

Message Text

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C O N F I D E N T I A L SECTION 1 OF 2 ADDIS ABABA 1783

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E.O. 11652: GDS
TAGS: ECON EFIN ET
SUBJ: UPDATE OF PROJECTED EPMG MILITARY PROCUREMENT AND ITS
ECONOMIC IMPACT

REF: A. ADDIS ABABA 0566, B. 76 ADDIS ABABA 9722

1. SUMMARY: EMB/MAAG RECENTLY COMPLETED ITS
SEMI-ANNUAL UPDATE OF THE ECONOMIC IMPLICATIONS OF
EPMG'S CURRENT INTENTIONS REGARDING PURCHASE OF MILI-
TARY GOODS AND SERVICES FROM THE US AND THIRD-COUNTRY
SOURCES. OUR CURRENT PROJECTION INDICATES AN INCREASED
LEVEL OF EXPECTED PROCUREMENT (FY 77-80) OF APPROX
US \$120 MILLION COMPARED WITH OUR LAST (JULY
1976) PROJECTION. THIS INCREASE IS PRIMARILY RELATED
TO THE PENDING AMMUNITION BUY AND INCREASED THIRD-
COUNTRY PROCUREMENT.

B. ONCE AGAIN WE HAVE CONCLUDED THAT THE FOREIGN
EXCHANGE COSTS OF THIS LEVEL OF PROCUREMENT CAN BE
ACCOMMODATED WITHOUT DETRACTING FROM EPMG'S DEVELOPMENT
EFFORTS. ETHIOPIA'S FOREIGN EXCHANGE RESERVES CON-
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TINUE TO BE VERY HIGH AND ETHIOPIA'S PROSPECTS FOR
FURTHER FOREIGN EXCHANGE EARNINGS ARE VERY GOOD,
MAINLY BECAUSE OF THE INTERNATIONAL COFFEE SITUATION.
WITH REGARD TO BUDGETARY IMPACT, WE BELIEVE THAT THE
LOCAL CURRENCY COSTS OF MILITARY EXPENDITURE ARE MORE
MANAGEABLE THAN PREVIOUSLY BECAUSE OF THE VERY HIGH
LEVEL OF TAX RETURNS FROM THE COFFEE EXPORT SURTAX.

IT SEEMS LIKELY THAT THE EPMG WILL EARN APPROX 350 MILLION BIRR MORE FROM THIS TAX IN THIS FISCAL YEAR THAN THE ORIGINAL BUDGET ESTIMATES HAD PROJECTED. EARNINGS FROM THIS TAX WILL CONTINUE TO BE VERY HIGH FOR THE NEXT TWO-THREE YEARS. CONSEQUENTLY, THE EPMG IS IN A RELATIVELY GOOD POSITION TO PURSUE A STRATEGY OF BOTH GUNS AND BUTTER FOR SEVERAL YEARS. END SUMMARY.

2. THE EMB AND US MAAG HAVE COMPLETED OUR SEMI-ANNUAL UPDATE OF OUR ASSESSMENT OF THE EPMG'S APPARENT INTENTIONS REGARDING PURCHASE OF MILITARY GOODS AND SERVICES FROM THE US AS WELL AS OTHER (THIRD-COUNTRY) SOURCES. ALL OF OUR PREVIOUS ASSUMPTIONS AND CAVEATS APPLY (SEE REFTELS). THIS TIME, HOWEVER, WE HAVE REORGANIZED THE TABLE TO HIGHLIGHT THE INCREASING IMPORTANCE OF PROCUREMENT FROM THIRD COUNTRIES. AS NOTED IN OUR LAST ASSESSMENT, EVALUATION OF THIS ASPECT OF THE EPMG'S INTENTIONS IS MUCH MORE DIFFICULT THAN THAT RELATED TO PROCUREMENT FROM THE US. THESE DIFFICULTIES INCLUDE IDENTIFICATION OF ITEMS LIKELY TO BE PROCURED, WHETHER THESE ITEMS WILL BE SUBSTITUTES FOR ITEMS WHICH HAD PREVIOUSLY BEEN PLANNED FOR PROCUREMENT FROM THE US OR ADDITIONAL TO THEM, AND THE METHOD OF FINANCING OF THESE ITEMS (GRANT, CREDIT, CASH). IN CONSTRUCTING THIS TABLE WE HAVE ERRED ON THE HIGH SIDE, I.E., ATTRIBUTED MORE THIRD-COUNTRY PROCUREMENT AS ADDITIONAL THAN WILL TURN OUT TO BE THE CASE. OUR VIEWS ON CAPITAL ITEM PROCUREMENT FROM THE US HAVE BEEN REVISED

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DOWNWARD, HOWEVER, IN AN ATTEMPT TO TAKE THIS POINT INTO ACCOUNT. THE O&M ESTIMATES INCLUDE ONLY US AND LOCAL (BUT NEVERTHELESS WITH FOREIGN EXCHANGE IMPACT) PROCUREMENT AS THE O&M FOR THIRD-COUNTRY (EXPECTED) INVESTMENT ITEMS WILL NOT BECOME SIGNIFICANT UNTIL THE END OF THE FIVE YEAR PERIOD, IF THEN.

MILITARY PROCUREMENT - CASH OUTLAY (US \$ MILLION)
US FISCAL YEAR

FY

FY 77/ FY 78 FY 79 FY 80 FY 81 TOTAL

76 77 78 79 80 81 (FY 76-80)

A. PREVIOUS

EST(8/76)1 55.8 97.0 49.6 51.5 61.9 - 315.8

(1PLUS2)

1.CAPITAL

INV. 53.1 81.7 18.8 25.3 31.1 - 210.0

2.O&M 2.7 15.3 30.8 26.2 30.8 - 105.8

(FY 77-81)

B.CURRENT

EST(2/77) 66.0 148.4 68.6 80.3 79.8 90.6 467.7

(1PLUS2)

1.US &

LOCAL

TOTAL 56.8 144.6 46.0 57.2 47.4 57.5 352.7

-CAP.INV.

(US ONLY) 52.7 125.4 18.8 19. 6. 15. 184.2

-O&M

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(US &

LOCAL) 3.7 14.0 21.3 32.5 36. 37.4 141.2

-CREDIT

(US ONLY) .5 5.2 5.9 5.7 5.4 5.1 27.3

2.THIRD

COUNTRY

TOTAL 9.2 3.8 22.6 23.1 32.4 33.1 115.0

1 INCLUDES THIRD-COUNTRY PROCUREMENT.

3. THIS ESTIMATE IS SUBSTANTIALLY HIGHER THAN OUR
LAST ESTIMATE IN LARGE PART BECAUSE OF THE SIZEABLE
PENDING AMMUNITION REQUEST AND AN INCREASE IN EX-
PECTED EPMG PROCUREMENT FROM THIRD COUNTRIES. FOR
THE FOUR YEAR OVERLAP PERIOD (FY 77/77-FY 80) THE
INCREASE AMOUNTS TO APPROX US \$120 MILLION.

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C O N F I D E N T I A L SECTION 2 OF 2 ADDIS ABABA 1783

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4. FOREIGN EXCHANGE IMPLICATIONS. AS WE HAVE DETERMINED IN PREVIOUS ANALYSES IN THIS SERIES, THE FOREIGN EXCHANGE IMPACT OF THE PROPOSED LEVEL OF PROCUREMENT WILL BE MANAGEABLE FOR THE NEXT SEVERAL YEARS. ETHIOPIA'S FOREIGN EXCHANGE EARNING POTENTIAL CONTINUES TO BE VERY HIGH AND EVEN IF INVESTMENT PROJECTS ARE UNDERTAKEN AND COMPENSATION PAYMENTS TO NATIONALIZED BUSINESSES ARE STARTED, IT SEEMS LIKELY THAT THE EPMG WILL BE ABLE TO ACCOMMODATE ALL OF THESE CLAIMS WITHOUT MAJOR DISLOCATIONS IN THE NEXT TWO YEARS OR SO. INFLATIONARY PRESSURES HAVE RECENTLY DECLINED, THEREBY RELIEVING PRESSURE ON THE GOVT TO INCREASE CONSUMER IMPORTS. MOREOVER, GOVT ATTITUDES TOWARD WESTERN DONOR ASSISTANCE APPEAR TO BE MORE POSITIVE THAN WAS THE CASE SIX MONTHS AGO SO FOREIGN EXCHANGE FINANCING FOR CERTAIN PROJECTS MAY COME FROM THESE SOURCES, ALTHOUGH THE EVENS OF FEB 3 HAVE INCREASED UNCERTAINTY RE EPMG INTENTIONS IN THIS AREA. IN SHORT, THE FOREIGN EXCHANGE IMPLICATIONS OF MILITARY PROCUREMENT AT THIS LEVEL ARE NOT ALARMING FOR THE SHORT RUN AND WITH PROPER MANAGEMENT SHOULD BE CONFIDENTIAL

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COMPATIBLE WITH ECONOMIC DEVELOPMENT OVER THE MEDIUM TERM.

5. BUDGET IMPLICATIONS. AGAIN, AS WAS POINTED OUT IN OUR LAST REPORT, THE EFFECTS OF MILITARY PROCUREMENT IN THIS AREA ARE SUBSTANTIAL. FURTHER INCREASES IN MANPOWER ARE UNDERWAY (SEE REF A) AND COSTS ASSOCIATED WITH INCREASED MILITARY ACTIVITY ARE ALSO MAKING GREATER DEMANDS ON THE MILITARY BUDGET. CONSEQUENTLY, THE GOVT MAY WELL BE FORCED TO (A) ALLOCATE MORE FUNDS FROM WITHIN THE EXISTING BUDGET AWAY FROM DEVELOPMENT AND FOR DEFENSE, (B) INCREASE THE RATE OF DEFICIT

FINANCING AND ALLOCATE THAT INCREASE TO THE DEFENSE BUDGET, (C) REDUCE OFFSHORE MILITARY PROCUREMENT BELOW CURRENT EXPECTATIONS, OR (D) EMPLOY SOME COMBINATION OF ALL THREE OF THE FOREGOING. ON THE OTHER HAND, REVENUE FROM COFFEE TAXES SHOULD BE VERY HIGH THIS YEAR (PERHAPS AS MUCH AS 350 MILLION BIRR ABOVE THE ORIGINAL ESTIMATE FOR THIS FISCAL YEAR) WHICH WILL EASE THE PRESSURE ON THIS YEAR'S BUDGET AND POSSIBLY FOR TWO OR THREE YEARS THEREAFTER. DESPITE THIS PROSPECT, SOME DEVELOPMENT PROGRAMS ARE EXPERIENCING SERIOUS BUDGET CONSTRAINTS FOR REASONS THAT ARE UNCLEAR. IT ALSO SHOULD BE NOTED THAT THE EPMG HAS NOT TAKEN ANY STEPS TO IMPROVE ITS ABILITY TO MOBILIZE DOMESTIC RESOURCES. SHOULD THIS CONTINUE TO BE THE CASE, WHEN THE REVENUE YIELD FROM THE COFFEE SURTAX DECLINES LACK OF DOMESTIC RESOURCES WILL AGAIN EMERGE AS A MAJOR CONSTRAINT.

6. CONCLUSIONS: THE EPMG CAN MANAGE CURRENTLY EXPECTED LEVELS OF MILITARY PROCUREMENT WITHOUT MAJOR DIFFICULTIES FOR THE NEXT FEW YEARS. IN FACT, IT IS PROBABLY BETTER PLACED TO ATTEMPT A
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"GUNS AND BUTTER" STRATEGY NOW THAN ANYTIME SINCE IT ASSUMED POWER. WHILE MANY FACTORS ACCUNT FOR THIS SITUATION, HIGH (AND STILL CLIMBING) COFFEE EARNINGS IS THE MAJOR REASON.
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